the <u>LEC Price Cap Order</u>. A LEC that was not able to achieve higher productivity growth than the Commission's standard would need a LFA in each year to achieve the 10.25% lower adjustment level, after the LFA was reversed each year. Thus, Bell Atlantic inadvertently shows in this chart that if the Commission did not allow add-back, it would impose a higher productivity standard on underearning LECs than it adopted in the <u>LEC Price Cap Order</u>.

Bell Atlantic includes different productivity changes in chart 1-4 to produce the same underlying rates of return as in chart 1-3, before add-back. By including arbitrary and unjustified productivity changes from year to year, Bell Atlantic makes it impossible to compare the results solely due to add-back vs. not adding back. This chart also implies a higher productivity standard because, after add-back, the LFAs in years 2, 3, 4, and 5 are lower than in year 1. Moreover, Bell Atlantic's methodology makes it appear that the sharing and LFA amounts are all attributable to year 1 when, in fact, they reflect the cumulative effect of LFA amounts for each year.

In charts 2-1 and 2-2, Bell Atlantic omits the productivity changes, but it miscalculates the year 3, 4 and 5 revenues. Bell Atlantic reverses the year 2 LFA twice in year 3, which should show the same revenues as in year 2 plus half the LFA amount for underearnings in year 2. These errors affect the calculation of LFA amounts for all years after year 2. Chart 2-2, because of these errors, incorrectly shows that, even with add-back, the LEC earns less than the 10.25% minimum rate of return. However, as the Commission demonstrated in the NPRM, add-back should allow an underearning LEC to earn up to, but not more than, the lower adjustment amount of 10.25% when all other factors are held constant.

Ameritech disputes the Commission's observation that the failure to include add-back creates a "see-saw" effect on earnings by presenting charts that allegedly show that, without add-back, the rate of return "stabilizes naturally."[10] The flaw in Ameritech's reasoning is that the rate of return "stabilizes" too high. Based on a 14.25% rate of return, a LEC should earn 13.25% after sharing 50% of revenues between 12.25% and 14.25%. Ameritech's exhibit shows that, without add-back, the LEC's rate of return stays well above 13.25% in years 3 through 6. The rate of return "stabilizes" (that is, the see-saw effect becomes less pronounced over time) only because sharing is limited to 50% of a LEC's overearnings. This was shown in the graph attached to the NTCs' initial comments in this docket. For a LEC earning below the lower adjustment level, the "see-saw" effect continues at the same magnitude because the LFA is based on 100% of the LEC's underearnings.

Ameritech also argues that add-back "pushes" a LEC into the sharing zone in subsequent years even if it only overearned in the first year.[11] In Ameritech's example, a LEC earns over 12.25 percent in the first year but not more than 12.25% in the second and subsequent years, without

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10 Ameritech at p. 5 and Exhibit 1.

11 Ameritech at p. 6.

add-back. With add-back, Ameritech shows that the sharing amount caused by year 1 throws the LEC into sharing for years 2 and 3. What Ameritech ignores is that the sharing obligation in year 2 would be reversed in year 3. If the LEC earned 12.25% in year 2 with sharing, but without add-back, it would earn in excess of 12.25% in year three after the sharing reversal. Therefore, the see-saw effect would occur, and the LEC would share the proper amount only every other year. Add-back is the only way to properly calculate the LEC's sharing obligation each year.

US West argues that add-back causes a LEC's calculated rate of return to rise each year even when its underlying operational results do not change.[12] However, its analysis conveniently assumes that the LEC's API is 10% below its PCI, so that the LEC does not have to change its rates despite the sharing adjustment to the PCI. Since sharing has no effect on actual revenues in US West's example, it is impossible to evaluate the effect of add-back. If the LEC's API were equal to its PCI, its rate of return after add-back would be the same each year. That is, if the LEC earned 14.25% in the first year, its normalized earnings would be 14.25% in the second year, after add-back of sharing revenues. This would produce the same sharing amount in the third year. The LEC's underlying rate of return would remain at 14.25%, and its actual or booked rate of return would be 13.25%, after sharing, each year after the base year. Thus, add-back does not inflate

12 US West at p. 8.

either the LEC's underlying rate of return or its reported rate of return -- it simply ensures that the rate of return for purposes of computing a sharing obligation is not artificially reduced by the amount of sharing from the previous year.

Finally, MCI objects that add-back (that is, removal) of LFA revenues permanently excludes LFA revenues from a LEC's rate of return calculations.[13] MCI notes that if LFA revenues due to underearnings in year 1 are removed from the rate of return calculation in year 2 through add-back, the revenues for both years are below actual billed revenues. However, this does not in any way undermine the earnings backstop mechanism. In effect, LFA revenues under add-back in year 2 are treated as having been "earned" in year 1. It only appears that total billed revenues are not included in the rate of return reports because the LEC does not retroactively change its rate of return for year 1. If the revenues that were removed from year 2 were included in year 1, the LEC's earnings for both years would be at the lower adjustment mark of 10.25%. This shows that add-back allows the LEC to recover underearnings in the previous year, and no more. The LFA revenues must be removed from the rate of return report for year 2 to properly calculate the LFA needed for year three to maintain the 10.25% rate of return after reversal of the year 2 LFA. Without add-back, the LEC's rate of return would be below 10.25% for the entire period.

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13 MCI at pp. 8-9 and Table 1.

Thus, none of these analyses does anything to undermine the Commission's demonstration of the need to normalize earnings by adding back sharing and LFAs.

III. LOWER FORMULA ADJUSTMENT REVENUES MUST BE REMOVED FROM EARNINGS TO COMPLY WITH THE PRICE CAP MINIMUM RATE OF RETURN

MCI supports add-back of sharing amounts but not of LFAs. MCI cannot have it both ways. Add-back performs the same function whether it is applied to sharing or LFAs -- it normalizes a LEC's rate of return for purposes of computing the sharing obligation or LFA amount for the next period.

MCI complains that removal of LFA revenues excludes revenues actually billed to customers.[14] Add-back of sharing could be criticized on the same basis, because it includes revenues that were not billed to customers during the current reporting period. In both cases, add-back simply removes the effect of additional revenues (in the case of an LFA), or of revenues that were not collected (in the case of sharing) in the current period due to events that occurred during the prior period.

MCI maintains that, under the previous rate of return regulation, the Commission never allowed the LECs to exclude revenues for purposes of computing their earnings.[15] This is incorrect. Under the rule that the LECs must report "earned" revenues during a reporting period, the LECs have always

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14 MCI at p. 6.

15 MCI at p. 11.

excluded revenues from backbilling (revenues collected in the current period for services that were provided in a previous period) from their reported earnings under both the rate of return and price cap systems. LFAs are similar to backbilling because they are "earned" in the previous period when the LEC underearned, and because they do not reflect the revenues that the LEC would otherwise have collected during the reporting period.

MCI also argues that the LECs never normalized rate increases under the rate of return rule.[16] This is true only because there were no out-of-period rate increases under the previous automatic refund rule, which had no mechanism for correcting underearnings in a previous period. Had the automatic refund rule included a mechanism for rate increases due to earnings in previous periods, the LECs would have been required to report "earned" revenues by excluding those revenues from the period in which they were received. This is similar to the treatment of refunds. Whether refunds are made through credits paid directly to specific customers or through prospective rate reductions, the LECs must normalize their revenues in the same manner by adding-back the refunds to their

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16 Id. MCI points out that the LECs did not normalize rate increases due to midcourse corrections under the rate of return regime. However, midcourse corrections were not out of period events. Those rate increases occurred during the reporting period to re-target earnings to the authorized rate of return during the remainder of the reporting period. Because they were not designed to recover underearnings that occurred during previous reporting periods, there was no need to normalize the revenues from those rate charges.

rate of return reports. For the same reasons, it is irrelevant whether a LEC receives out of period revenues in the form of backbilling or an LFA rate increase -- the LEC must still exclude those revenues from its earnings to report earned revenues for the current reporting period.

MCI also criticizes add-back when applied to LFA because it "guarantees" that a LEC will earn at the lower adjustment mark of 10.25%.[17] MCI argues that the Commission did not establish 10.25% as the minimum rate of return for price cap LECs.[18] It notes that under the previous rate of return regime, the LECs were required to refund overearnings but were not allowed to raise prices for underearnings. This is true, and it is also why the automatic refund mechanism was overturned in AT&T v. FCC.[19] The court found that a system that automatically refunded overearnings but provided no relief for underearnings would, over time, drive a carrier's return below the minimum level that the Commission had determined was necessary for the carrier to stay in business. In the LEC Price Cap Order, the Commission avoided the flaw in the automatic refund rule by adopting a minimum rate of return

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17 MCI at pp. 12-14. MCI does not object to the fact that add-back "guarantees" that a LEC in the sharing mode will not earn more than the maximum of 14.25%. While MCI's self-interest in policies that will reduce rates is understandable, the Commission must adopt a consistent approach to add-back for both sharing and LFAs.

18 MCI at pp. 10-12.

19 American Tel. & Tel. Co. v. FCC, 836 F.2d 1386 (D.C. Cir 1988).

along with a mechanism -- the LFA -- to provide relief for a carrier that earned below the lower limit.

The Commission adopted the lower adjustment mark based on its unequivocal finding that a LEC earning less than 10.25% over an extended period of time would be unable to maintain service.[20] By setting the lower limit 100 basis points below the authorized rate of return of 11.25%, the Commission gave underearning LECs an incentive to improve their productivity, without setting the lower limit so low as to endanger their ability to remain in business.[21] MCI's issue is not with the NPRM, which does nothing more than ensure that the LFA is properly computed to bring earnings up to 10.25%, but with the price cap system that the Commission adopted in 1990. These arguments are irrelevant to the NPRM, and MCI should reserve them for the Commission's upcoming review of the price cap system.

The NPRM demonstrates that if LFA revenues are not removed, an underearning LEC may earn at 10.25% in some years, but that the "see-saw" effect would ensure that the LEC would underearn over an extended period. Thus, a failure to exclude

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20 See LEC Price Cap Order at para. 148.

21 LEC Price Cap Order at paras. 164-65. Thus, Bell Atlantic misses the point when it quotes the LEC Price Cap Order to argue that the Commission rejected the notion that the price cap system should guarantee the LECs that they will achieve earnings at the full rate of return. See Bell Atlantic at p. 3. The "full" level of the prescribed rate of return is 11.25%. The backstop mechanism that the Commission adopted only increases LEC earnings up to 10.25%, in order to retain an incentive for increased efficiency.

LFA revenues would clearly be inconsistent with the Commission's price cap backstop mechanism for low earnings.

IV. SHARING DOES NOT HAVE TO BE EQUATED WITH REFUNDS TO JUSTIFY ADD-BACK

Some of the commenters oppose add-back on the grounds that the Commission is attempting to turn the price cap sharing mechanism into a rate of return refund mechanism.[22] They argue that refunds are backward-looking attempts to correct past overearnings, while the price cap backstop mechanism is a forward-looking effort to re-target earnings.[23] Some even argue that add-back is prohibited because it constitutes retroactive ratemaking.[24] These arguments miss the point. Regardless of whether sharing is a refund mechanism or not, normalization of a LEC's rate of return is necessary to properly implement the policies that the Commission adopted in the LEC Price Cap Order.

The Commission's policies on sharing and LFAs are quite clear. Sharing and LFA amounts are calculated based on

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22 See, e.g., GTE at p. 5.

23 See, e.g., MCI at pp. 18-19.

24 See, e.g., GTE at p. 5; Ameritech at pp. 2-3. Ameritech misquotes the Commission's Price Cap Reconsideration Order by making it appear that the Commission decided that "Sharing is intended as a means of sharing prospective productivity gains, and not a refund mechanism." Ameritech at p. 3. The language it quotes is a summary of the comments of BellSouth in that proceeding, and it is not a finding by the Commission. See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No 87-313, Order on Reconsideration, FCC 91-115, released April 17, 1991, p. 50 n.148

the base year, i.e., past period, rate of return. The sharing and LFA adjustments that are calculated in this manner are made to the future period rates as a one-time adjustment. Thus, these adjustments are not designed to target future rates to a particular rate of return; they are always calculated with regard to past period earnings. It is too late in the game for a party to oppose this process or to characterize it as retroactive ratemaking, since the period for petitions for reconsideration of the price cap policies has long passed. The only issue at this point is whether add-back is necessary to carry out those policies. The NPRM clearly demonstrates that it is. Without add-back, a LEC's rate of return does not reflect its underlying financial results, and it is impossible to enforce the earnings limitations of 10.25% on the low end and 14.25% on the high end.

V. THE NPRM CLARIFIES, RATHER THAN MODIFIES, THE REQUIREMENTS OF THE COMMISSION'S PRICE CAP RULES

BellSouth disputes the Commission's characterization of the NPRM as a clarification of the requirements of the price cap rules, rather than as a rule change, and it argues that the Commission cannot apply a rule change retroactively.[25]

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25 See, e.g., BellSouth at pp. 3-9. See also AT&T at p. 6. BellSouth also cites the NPRM for the proposition that ratepayers would be harmed by retroactive application of add-back because it would increase rates by $20 million. BellSouth at p. 8. This is incorrect. BellSouth cites the Commission's calculations of the 1992 sharing and LFA amounts, which do not represent the impact of add-back on 1993 sharing levels, which are affected by the LECs' underlying 1993 rates of return. The NTCs calculate that add-back would reduce nationwide access rates by over $20 million if applied to 1993 rates.

BellSouth rests its case entirely on the technicalities of the Form 492A report, and it does not refute the Commission's findings that (1) the existing rules place the burden on the LECs to calculate sharing amounts in accordance with the Commission's sharing mechanism, and (2) the only way to properly calculate a LEC's sharing obligation is to add back the effects of sharing or LFAs for previous periods. Nor does BellSouth dispute the fact that the Commission retained the Form 492 requirement that LECs report earned (i.e., normalized) revenues. These requirements, which predate the NPRM, effectively refute BellSouth's argument that the NPRM proposes a retroactive rule change. Clearly, the NPRM merely clarifies the requirements of the Commission's price cap rules, and the principles described in the NPRM apply with full force to the issues in the pending investigation of the 1993 Annual Access Tariffs.

BellSouth is wrong in its analysis of how the revised Form 492 requires the LECs to report their rates of return. BellSouth notes that the previous Form 492 report contained a line 6 to itemize refunds in the base period, and that it required the LEC to subtract this amount from the operating income on line 3 to produce a "net return" on line 7. In the revised Form 492A, the Commission retained a line for FCC-ordered refunds (line 7) and it added a line for sharing and LFA amounts (line 6), but it did not retain a final line that would have required the LECs to add-back the sharing/LFA amount or the FCC-ordered refund amount to produce a "net return" similar to the previous line 7.[26] According to BellSouth, this "makes it clear that add-back forms no part of the rate of return calculations under the LEC price cap orders or rules."[27] This argument proves too much. If the absence of a final line requiring the LECs to add-back sharing/LFA amounts on line 6 were dispositive, then the same would be true of the FCC-ordered refunds on line 7. Yet, even Ameritech admits that the LECs must normalize their revenues on line 1 by adding-back the FCC-ordered refunds on line 7.[28] Thus, the fact that these items are broken out on lines 6 and 7 does not mean that the Commission changed its rules on out-of-period adjustments. To the extent that sharing/LFA amounts, FCC-ordered refunds, backbillings, and credits for overbillings are calculated and applied with reference to past periods, the effect of these items must be excluded from "booked" revenues to show "earned" revenues on line 1. The fact that the Commission modified the Form 492 to eliminate separate calculations of the effect of refunds does not mean that the Commission amended its normalization rule _sub silentio_.

Thus, the rule has always been that the LECs must normalize their revenues for _all_ out-of-period events, including sharing/LFA revenues. In addition, normalization through add-back is implicit in the rules on the backstop

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26 _See_ BellSouth at pp. 5-6.

27 _Id._

28 _See_ Ameritech at p. 3.

sharing and LFA mechanism. No commenter has provided any evidence to the contrary.

VI. THE NYNEX TELEPHONE COMPANIES AGREE THAT THE COMMISSION SHOULD ENHANCE THE INCENTIVES FOR THE LECs TO BECOME MORE EFFICIENT BY ELIMINATING SHARING IN ITS REVIEW OF THE PRICE CAP RULES

Several parties argue that add-back limits the incentives for the LECs to become more efficient by limiting their potential earnings.[29] We agree. However, that is because add-back enforces the 14.25% upper limit on earnings that the Commission adopted in the LEC Price Cap Order. Such a limit dampens the incentive of the LECs to take risks when investing in the domestic network infrastructure because their potential gains are limited. The price cap system already protects ratepayers through the caps on price increases. There is no need to engraft further "protections" by placing an inflexible ceiling on the earnings that the LECs can achieve by investing in the telecommunications network.

The way to encourage innovation and risk-taking is not to re-interpret the Commission's existing rules on the backstop mechanism by deciding that normalization never existed. Rather, the Commission should amend its price cap rules to eliminate sharing, which makes the issue of how to calculate rates of return moot. For this reason, the NTCs support the commenters that urge the Commission to eliminate sharing in the upcoming review of the price cap rules.[30]

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29 See, e.g., Pacific Companies at pp. 2-4; USTA at pp. 2-5

30 See id.

VII. CONCLUSION

For the foregoing reasons, the Commission should adopt its proposed rule to clarify that the LECs should add-back the effects of sharing and LFAs in calculating their rates of return for the backstop earnings mechanism.

Respectfully submitted,

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Dated: September 1, 1993

Before the
Federal Communications Commission
Washington, D.C. 20554

CC Docket No. 93-179

In the Matter of

Price Cap Regulation of
Local Exchange Carriers

Rate of Return Sharing
And Lower Formula Adjustment

NOTICE OF PROPOSED RULEMAKING

Adopted: June 18, 1993; Released: July 6, 1993

Comment Date: August 2, 1993
Reply Date: September 1, 1993

By the Commission:

I. INTRODUCTION AND SUMMARY

1. Under the Commission's price cap plan, a local exchange carrier's (LEC's) interstate rate of return in one year can be the basis for adjustments to that carrier's price cap indexes in the following year. This rate of return "backstop" is intended to tailor the plan to the circumstances of individual LECs, while assuring that customers share in productivity gains. In order to preserve the efficiency incentives of price caps, this adjustment to the indexes applies only to the next year's allowable rates, and only if the LEC's rate of return falls outside a broad range around the rate of return used to begin LEC price caps, 11.25 percent. The LEC generally begins to share half of its earnings with customers beginning at a 12.25 percent rate of return; all earnings above 16.25 percent are returned to customers through this adjustment. Similarly, at the low end, if the LEC's earnings fall below 10.25 percent, an upward adjustment in the price cap indexes is permitted in the following year.

2. LEC price cap rates took effect on January 1, 1991, and the first application of this sharing and lower adjustment mechanism occurred in the annual 1992 access tariff filings, which were filed in April 1992 and took effect on July 1, 1992. LECs with rates of return above 12.25 percent during 1991 lowered their price cap indexes by a total of $76.8 million to share earnings. LECs with rates of return below 10.25 percent increased their indexes by a total of $96.6 million.

3. In the annual 1993 access tariff filings, an issue has arisen as to how such sharing and lower end adjustments to the price cap indexes should be reflected in the rate of return used to determine sharing and lower formula adjustments in the following year. Some price cap LECs have proposed that the rate of return used to compute this year's backstop adjustments should include the effects of last year's backstop adjustment. This approach would reduce sharing amounts this year for LECs who were subject to sharing last year. However, under rate of return regulation we have required LECs to "add-back" an adjustment for rate of return-based refunds from prior periods. "Add-back" would also increase the lower end adjustment, and thus permit higher rates, for LECs who received that adjustment last year.

4. Our review of the LEC price cap plan, and the rules and orders implementing it, indicates to us that the amounts of the backstop adjustments should probably not be included when computing the rates of return used to determine sharing and lower end adjustments in the following year. As we discuss below, we believe that "add-back" is more consistent with the price cap plan as it was adopted. However, we recognize that this issue was neither expressly discussed in the LEC price cap orders nor clearly addressed in our Rules. "Add-back" also poses implementation issues that it may be useful to air and resolve now that the first tariffs raising this issue are before us. Accordingly, we are establishing this docket to seek comment on the tentative conclusion discussed below, and on proposed rule changes, to incorporate "add-back" clearly into the LEC price cap rules.

II. DISCUSSION

A. Add-Back In Rate of Return Regulation

5. Under rate of return regulation, LECs refund overearnings above the prescribed maximum allowable rate of return, whether through direct payments to customers, rate reductions in a subsequent tariff filing period, or damages awarded after complaints. Because the rate of return prescription applies to a LEC's performance and rates within a specific monitoring period, we have required LECs to treat refund payments as adjustments to the period in which the overearnings occurred, rather than to the period in which the refund is paid.[1]

6. This approach is implemented by including a line-item on the rate of return monitoring report, Form 492, which displays the amount of refunds associated with prior enforcement periods.[2] The refunds are then "added back" into the total returns used to compute the rate of return for the current enforcement period.[3] The net rate of return after add-back is then used to determine compliance with the prescribed rate of return during the new enforcement period, and to compute the amount of any refund obligation.[4]

[1] Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements, CC Docket No. 86-127, 1 FCC Rcd 952, 956-57 (1986).

[2] *Id.* at 960-961, Appendix C.

[3] Section 65.600 of the Commission's Rules, 47 C.F.R. Section 65.600.

[4] Sections 65.700-03 of the Commission's Rules, 47 C.F.R. Section 65.700-03.

B. The Rate of Return Backstop in the LEC Price Cap Plan

7. A pure price cap plan seeks to establish reasonable rates by capping prices rather than profits. For example, in our AT&T price cap plan maximum prices are limited by a formula that adjusts the price cap indexes (PCIs) annually based on inflation and a productivity target, not the carrier's own costs.[5] The Commission was concerned, however, that a pure price cap plan might produce unintended results as applied to the many individual LECs and their varying operational and economic circumstances.[6] For this reason, the Commission included a rate of return-based backstop mechanism in the LEC price cap plan. The plan retains productivity incentives by allowing LEC earnings to vary within a wide range around the initial 11.25 percent rate of return. Outside that range, the sharing and lower formula adjustment apply to adjust the price cap index.[7]

8. We anticipated that the backstop would operate in much the same way as rate of return enforcement for LECs still subject to rate of return regulation. Rates of return would continue to be calculated and reported in essentially the same manner.[8] Where we found that changes in the application of the rate of return were appropriate, we specifically adopted them. These changes included the wider range of earnings, the exclusion of the LEC price cap earnings thresholds from the rate of return represcription process, and the deletion from earnings reports of information not needed under the price cap plan.[9]

9. We adopted the sharing and lower end adjustment mechanisms both as rules and prescriptions, similar to the prescription applied to rate of return carriers.[10] We also made clear that we expected the mechanisms to enforce the earnings limits we had adopted, in order to assure that rates would remain within a range of reasonableness, and that particular LECs could not retain unusually high earnings that were not necessarily tied to increases in productivity. Section 61.45(d)(2) requires that price cap LECs "shall make such temporary exogenous cost changes as may be necessary to reduce PCIs to give full effect to any sharing of base period earnings required by the sharing mechanism...." *See also* Section 61.45(d)(1)(vii).

C. The Add-Back Issue for the Price Cap Backstop

10. Our initial review of the record does not indicate that any commenters in the LEC Price Cap rulemaking or in the subsequent reconsideration proceeding discussed the details of rate of return calculations, or requested that we eliminate add-back from the rate of return calculations of the LEC price cap plan. In discussing and adopting changes in rate of return monitoring and reporting, we also did not indicate that the add-back provisions in Form 492, which is used to report returns, were to be changed.

11. We have also examined the effects of add-back and believe that it continues to be an appropriate and indeed probably necessary component of the backstop. First, as discussed in the *LEC Price Cap Order*, the price cap plan is intended to create incentives for productivity growth. Changes in rate of return each year are used as a measure of productivity growth relative to the price cap target. The amounts of sharing or lower formula adjustment implemented in one year, however, relate to productivity performance in a prior year. Thus, unless add-back occurs, the relationship between rate of return and productivity growth becomes hidden.

12. Second, without add-back, artificial swings in earnings can occur. As the example in Appendix A illustrates, the use of unadjusted rates of return for backstop calculations create a "see-saw" effect on earnings, even if the carrier's operational performance was the same each year. This can occur because the unadjusted rate of return effectively double-counts the amount of the backstop adjustment, once in the base year and then again in the tariff year.

13. Third and most important, add-back appears necessary to the rate of return thresholds applied to determine price cap LECs' sharing obligations and lower adjustment right are those we intended. The price cap plan gives the LECs substantial flexibility in their rates and earnings, to encourage greater efficiency. However, for the LECs the Commission established limits on this flexibility and a range of reasonableness for LEC earnings. Without add-back, the double-counting of backstop adjustments could effectively permit earnings outside the range of reasonableness we designated. LECs would share less of their earnings as they approach or exceed the high end of the range, and would receive smaller adjustments when they fell below the low end of the range. In both cases, the effective rate of return over time could fall outside the range of returns we judged to be reasonable. Rates of return would not be limited to the 16.25 percent maximum we established for LECs electing a 3.3 percent productivity factor, nor would earnings below 10.25 percent be adjusted upward to 10.25 percent. This effect is illustrated in the examples in Appendix A. The examples also show that this discrepancy could be quite significant. In the current annual access tariff filings, use of the unadjusted rate of return for computing this year's backstop adjustments would permit rates of return that would be on average 0.2 percent higher at the upper end, and 0.5 percent lower at the low end than the adjusted rate of return. For individual LECs, the effect is often greater still, as much as 2.0 percent above and 0.9 percent below the rate of return calculated without the adjustment.[11] The add-back adjustment corrects these deviations and sets the backstop rate of return limits at the levels we selected in the *LEC Price Cap Order*

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[5] Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2922-33 (paras. 100-114) (1989) (*AT&T Price Cap Order*); Erratum, 4 FCC Rcd 3379 (1989).

[6] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6801 (1990) (*LEC Price Cap Order*).

[7] For LECs who elect a productivity factor of 3.3 percent during the tariff year, the 50 percent sharing obligation begins for rates of return above 12.25 percent, and 100 percent sharing begins at 16.25 percent. For LECs who elect the more challenging 4.3 percent productivity factor, 50 percent sharing begins for rates of return above 13.25 percent, and 100 percent sharing begins at 17.25 percent. The lower formula adjustment remains at 10.25 percent in both cases. *LEC Price Cap Order*, 5 FCC Rcd at 6787-88 (paras. 7-10).

[8] *LEC Price Cap Order*, 5 FCC Rcd at 6832 (para. 373)

[9] *LEC Price Cap Order*, 5 FCC Rcd at 6827-34 (paras. 332-84).

[10] *LEC Price Cap Order* at 6836 (paras. 403-414)

[11] For example, in the annual 1992 access tariff filing, Ameritech calculated a sharing obligation of $18.2 million and reduced its rates on July 1, 1992 to return that amount to ratepayers. Thus, Ameritech's revenues were about $9 million lower in 1992 that they would have been without sharing during the second half of the year. Ameritech reported its rate of

14. By reducing the range of earnings permitted under the backstop, however, add-back does reduce the efficiency incentives. Moreover, to the extent that the sharing and lower end adjustments under price caps are not refunds, it might be argued that the rate of return methodology used to define sharing obligations and lower formula adjustments should be based upon the returns achieved under the rates actually charged during the base year.

15. Based upon our review of this issue, we tentatively conclude that the add-back adjustment should continue to be part of the rate of return calculations of LECs subject to price caps, preceding their calculations for purposes of the backstop sharing and lower formula adjustments. We propose specific rule language in Appendix B to implement this tentative conclusion. We also request comments on this tentative conclusion and other mechanisms to deal with the issues we have discussed.

D. Credit for Below-Cap Rates

16. Use of add-back would present at least one further issue: whether a LEC that has set its rates below the price cap indexes during the base year should receive credit for the amount between its PCI and its API, or actual prices, in calculating its sharing amounts. In a sense, the LEC has already passed through some rate reductions by pricing below the cap. Allowing credit for below-cap rates would encourage carriers to charge lower, below-cap rates. Conversely, if the LEC's low earnings in one year are in part the result of its own decision to set rates below the cap, the rationale for allowing an upward adjustment in the cap the next year would seem to be less persuasive. Moreover, we established the alternative 4.3 percent productivity factor as an option for LECs who are willing to make larger upfront rate cuts in exchange for reduced sharing requirements. We did not specify other adjustments to sharing obligations, and declined to adopt a plan that would have automatically reduced sharing based upon the actual rates set by the LEC.[12] We request comment on whether LECs should be given credit for below-cap rates in the price cap backstop mechanism and how such a credit would be calculated.

III. PROCEDURAL MATTERS

17. *Regulatory Flexibility Act.* We certify that the Regulatory Flexibility Act of 1980 does not apply to this rule making proceeding because if the proposed rule amendments are promulgated, there will not be a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act. Local exchange carriers subject to price cap regulation, who would be affected by the proposed rule amendments, generally are large corporations or affiliates of such corporations. The Secretary shall send a copy of this Notice of Proposed Rule Making, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 603(a) of the Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. Section 601 *et seq.* (1981).

18. *Comment Dates.* Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules, 47 C.F.R. Sections 1.415 and 1.419, interested parties may file comments on or before August 2, 1993 and reply comments on or before September 1, 1993. To file formally in this proceeding, you must file an original and four copies of all comments, reply comments, and supporting comments. If you want each Commissioner to receive a personal copy of your comments, you should file an original plus nine copies. You should send comments and reply comments to Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the FCC Reference Center, Room 230, 1919 M Street, N.W., Washington, D.C. 20554.

19. *Ex Parte Rules - Non-Restricted Proceeding.* This is a non-restricted notice and comment rulemaking proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in Commission Rules. *See generally* 47 C.F.R. Sections 1.1202, 1.1203, and 1.1206(a).

For further information on this proceeding contact Dan Grosh, Tariff Division, (202) 632-6387.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary

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return for 1992 at 12.79 percent without add-back. An add-back adjustment of $9.1 million, along with the federal income tax effect, would raise Ameritech's rate of return to 12.99 percent. This 0.2 percent difference in rate of return would generate an additional $3 million in sharing obligation during the access year beginning on July 1, 1993.

Conversely, Contel of the South, which had a low end add-back, its adjusted 1992 rate of return would be 8.15 percent. Use of the adjusted rate of return in the low end adjustment would permit an additional $1 million in low end adjustment for Contel in the forthcoming access year.

12 *LEC Price Cap Order*, 5 FCC Rcd at 6803 (paras. 38-39).

APPENDIX A

o Consider the company whose earnings are as shown below, which makes its refunds through a refund check each December 31

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,425	2,425	2,425
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	14.25	14.25	14.25
Refund	100	100	100	100
ROR with Refund	13.25	13.25	13.25	13.25

o Contrast this with the effect on this same company with a sharing plan to implement the refunds, but without an add-back

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,375	2,350
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	13.25	13.75	13.50
Sharing to be returned in next year	100	50	75	62.50

- This company shares less and reports a different rate of return each year, even though its underlying costs did not change

o Contrast this result with the effect of including the add-back

	Year I	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,325	2,325
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	13.25	13.25	13.25
Add-back	0	100	100	100
ROR with Add-back	14.25	14.25	14.25	14.25
Sharing	100	100	100	100

o Thus the company which includes the add-back in its rate of return computation has the same rate of return and returns the same amount of money to ratepayers as the company which makes its refund by a check.

- Consider the company whose earnings are as shown below, which receives its low-end adjustment through a check each December 31

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	1,925	1,925	1,925
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	9.25	9.25	9.25
LowEnd Adj	100	100	100	100
ROR with Adj	10.25	10.25	10.25	10.25

- Contrast this with the effect on this same company with an exogenous adjustment to implement the low end adjustments, but without an add-back

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	1,925	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	10.25	9.25	10.25
Low End Adj to be re-gained in next year	100	0	100	0

  - This company receives less low end adjustment and reports a different rate of return each year, even though its underlying costs did not change

- Contrast this result with the effect of including the add-back

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	2,025	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	10.25	10.25	10.25
Add-back	0	-100	-100	-100
ROR with Add-back	9.25	9.25	9.25	9.25
LowEnd Adj	100	100	100	100

- Thus the company which includes the add-back in its rate of return computation has the same rate of return and receives the same amount of money as the company which receives its low end adjustment in a check.

APPENDIX B

Proposed Rule Section

Part 61 of Title 47 of the Code of Federal Regulations is proposed to be amended as follows: 1. The authority citation for Part 61 continues to read as follows:

AUTHORITY: Sec. 4, 48 Stat. 1066, as amended: 47 U.S.C. 154. Interpret or apply sec. 203, 48 Stat. 1070: 47 U.S.C. 203.

2. **Section** 61.3(e) is revised by adding the following **bracketed language**: Section 61.3 **Definitions**

(e) **Base Period.** The 12 month period ending six months prior to the effective date of annual price cap **tariffs.** [**Base year or base period earnings shall not include amounts associated with exogenous adjustments to the PCI** for the sharing or lower formula adjustment mechanisms.]